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RUEHKT/AMEMBASSY KATHMANDU 6408  
RUEHKP/AMCONSUL KARACHI 2419  
RUEHCG/AMCONSUL CHENNAI 8835  
RUEHBI/AMCONSUL MUMBAI 6220  
RUEHC/DEPT OF LABOR WASHDC  
RUEATRS/DEPT OF TREASURY WASHDC  
RUEHLMC/MILLENNIUM CHALLENGE CORPORATION

UNCLAS SECTION 01 OF 03 COLOMBO 001133

SENSITIVE

SIPDIS

STATE FOR SCA/INS AND EEB/IFD/OMA  
STATE PASS USTR FOR ADINA ADLER AND VICKY KADER  
COMMERCE FOR EROL YESIN, BRIAN WILLIAMS  
DOL/ILAB FOR TINA MCCARTER  
TREASURY FOR ANNE ALIKONIS

E.O 12958: N/A  
TAGS: [ECON](#) [EFIN](#) [PGOV](#) [KMCA](#) [CE](#)  
SUBJECT: SRI LANKA: FINANCING HARDSHIPS IN NEW YEAR

REF: (A) COLOMBO 1127  
(B) COLOMBO 1107

¶1. (SBU) Summary: Sri Lanka's macroeconomic outlook for 2009 is weakening. In November Central Bank reserves declined, for the fourth straight month, to around \$2 billion, or less than 2 months of imports. The trade deficit in the first ten months expanded by 78%, and the Central Bank (CB) expects a balance of payments (BOP) deficit of about \$500 million in 2008. Analysts argue for a depreciation of the rupee to boost exports and reign in the trade deficit. Sri Lanka will face external debt servicing costs of over \$1 billion in the new year. Although Sri Lanka has not defaulted on loan payments in recent times, the possibility of default in 2009 cannot be ruled out. End Summary.

DEFENDING THE RUPEE,  
DEPLEATING FOREIGN RESERVES  
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¶2. (SBU) The Sri Lankan rupee is under severe pressure due to a large trade deficit and foreign bond holders exiting the market. GSL external debt service payments are expected to rise in 2009, adding additional pressure. To date, Central Bank sources report that the CB has spent around USD one billion defending the rupee in 2008 in order to keep the rupee-dollar exchange rate relatively stable. (Note: On October 30, the rupee was marginally devalued from 108 to 110. The rupee is currently trading at 111 to a dollar.) The rupee nevertheless appreciated against most other major currencies in 2008 (to date 10% against the Euro, 18% against the Indian rupee).

¶3. (SBU) Although Sri Lanka recorded a BOP surplus of \$173 million at end September, according to Assistant Central Bank Governor H. N. Thenuwara the CB expects a BOP deficit of about \$500 million by year end. Sri Lanka's official reserves dwindled to around \$2 billion in November, down from \$3.06 billion in January. According to documents released with the 2009 budget, Sri Lanka's external debt service cost (interest and amortization) will be over \$1 billion in ¶2009. In previous years, the government easily rolled over the debt; that will be difficult in 2009 given the global credit crunch. The government will also be called on to payback an Iranian credit line used to import oil.

¶4. (SBU) Despite concerns about foreign reserves, the GSL is not willing to accept condition-based foreign aid, and it (at present) rejects the possibility of IMF facilities in 2009. The GSL continues to resort to commercial loans to finance its deficit. In 2008 the Central Bank raised approximately \$550 million through a variety of commercial sources, including state banks, two-year Sri Lanka Development Bonds, and a syndicated loan. However, the government's last attempt to raise \$300 million in October failed, and in December an Indian bank withdrew plans to provide a \$25 million loan to the GSL.

¶5. (SBU) As a result, the Central Bank is trying to curb fund outflows. It introduced controls on forward contracts of foreign exchange, prohibited prepayment of import bills, and imposed a 100 percent margin on letters of credit when importing non-essentials. The margin requirement on the import of cars has been increased to 200%. (Note: Imported cars are taxed at between 206% - 503%.) The government also increased taxes on non-essentials in an effort to curb imports.

¶6. (SBU) On the bright side, remittances increased by more than 22% in the first nine months of 2008. However, while remittances traditionally help to finance about 70% of the trade deficit, they could not keep pace with the trade deficit increase in 2008. The possibility of decreasing remittances as employment opportunities shrink in oil producing countries remains a concern, despite

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government projections that remittances will increase in 2009.

#### INFLATION -----

¶7. (SBU) Inflation declined to 16.3% in November after decelerating gradually since its peak of 28.2% in June 2008. The 2008 annual average inflation is now trending now more slowly at 23%. The slow down in inflation was due primarily to the fall in world prices of oil and food. However, the Central Bank's tight monetary policy also helped to moderate inflation; the CB cut its money supply target thrice in 2008 to reduce money in circulation. Citing a liquidity short fall in the money markets, the Central Bank eased monetary policy in late November by reducing reserve requirements for commercial banks. The bank said its actions will not pose any threat to the inflation outlook since inflation is decelerating "at a faster rate than expected."

#### TRADE DEFICIT INCREASES 78% -----

¶8. (SBU) Total exports through end October increased 9%. Total imports increased a staggering 31% during the same period, primarily due to higher oil prices earlier in the year. Consequently, the ten-month trade deficit widened by 78% to \$5.2 billion in 2008 from \$2.9 billion in 2007. Despite an overall increase in exports to date, the initial effects of the global recession are apparent in Sri Lanka's exports sector. Demand for Sri Lanka's major agricultural products, such as tea, rubber and coconuts, has weakened. Tea and rubber are hurting the most as prices, which reached record highs in early 2008, have decreased by 30% and 50%, respectively, since mid-September. Other manufactured items, such as rubber, ceramic, and leather products dropped sharply in September-October. Apparel exports may be a bright spot; although exports recorded a sharp decline in September, they increased by 13% in October (year on year).

#### CONCERNS FOR THE NEW YEAR -----

¶9. (SBU) Experts agree that Sri Lanka will have trouble meeting its external funding requirements in 2009. On December 9, ADB Country Manager Dr. Richard Vokes publicly underscored his doubts about the

ability of the government to raise commercial loans in 2009. Vokes is not alone. In November, S&P categorized Sri Lanka as significantly at risk of a credit rating downgrade due to a global recession and scarce funds, underlining that Sri Lanka is facing risks due to high short term commercial debt and high fiscal deficits. In mid October, the IMF said in its annual Article IV review that reliance on foreign debt to finance the deficit could destabilize the Sri Lankan economy. IMF also said that amid increasing international risk aversion, raising external finance will become increasingly challenging. According to Saman Kelegama of the Institute for Policy Studies (a well-respected local economic think tank), if Sri Lanka faces a sharp recession in 2009, it will not be able to fund a stimulus package because the country has been running huge budget deficits for too long and the macro economic fundamentals are already too weak.

¶10. (SBU) Many economists argue for the depreciation of the rupee. Local economic analysts and businesses argue that the rupee is overvalued -- some say by 20% -- and must be depreciated immediately. Vokes said Sri Lanka should seriously consider depreciating the rupee in light of the worsening trade deficit and depleting reserves. Advisors to the Central Bank are pleading for depreciation (ref b). Kelegama notes that although depreciation will likely fuel inflation, the right time for a depreciation is now as inflation is on the decline and world commodity prices are at low levels.

COMMENT

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¶11. (SBU) Significant expenditure restraint in the new year, in

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light of the ongoing conflict and President Rajapaksa's commitment to the public sector, is extremely unlikely. Although the government continues to reject the possibility of IMF facilities, if commercial options are unavailable, hoped-for increases in remittances and Diaspora investment fail to materialize, and/or bilateral friends fail to give the GSL a helping hand, the government will be forced to reconsider this position in 2009.